

# Corporate Governance and Financial Performance of Savings and Credit Co-Operatives in Embu County, Kenya

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## Corporate Governance and Financial Performance of Savings and Credit Co-Operatives in Embu County, Kenya

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### Abstract

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*was used to select the sample. Primary data was collected using self-administered semi-structured questionnaires while secondary data was obtained from financial statements and periodicals using a record survey sheet. Pre-testing of research tool was conducted before the actual data collection was carried, to determine the reliability of the questionnaire by use of a Cronbach's alpha, statistical coefficient, while the validity was tested to ensure that the questions in the questionnaire provides adequate coverage to the investigative questions. Correlation and multiple regression analysis was used to establish the relationship between independent and dependent variables. The study findings indicated that corporate governance positively affected the financial performance. In specific the board composition and corporate risk management for SACCOs had a positive effect on the financial performances of the SACCOs. The study is beneficial to SACCOs management in improving the performance of Savings and Credit Co-operatives and enabling them to compete globally. The study recommends gender parity consideration and balanced mix of skilled board members during appointments of the board members. The recommendations are important to the government, especially the department of cooperatives in strengthening policies regarding cooperative societies.*

*Corporate governance is of great importance for financial performance. Corporate governance issues have attracted public interest in the financial sector both locally and internationally after waves of corporate rip-offs and failures that almost led to loss of confidence in the finance sector. The general objective of this study was to determine the effect of corporate governance on financial performance of Savings and Credit Co-operatives in Kenya. The study adopted a descriptive research design. The study targeted a population of 65 active Savings and credit Co-operatives operating in Embu County. A sample size of 57 Savings and Credit Co-operatives was used in this study. Stratified sampling technique*

### 1.0 Introduction

One of the principal challenges which Savings and Credit Co-operatives (SACCOs) face is establishing proper governance systems (Odera, 2012). Good governance can improve the performance of a SACCOs and help assure its long term survival (Thomsen, 2008). The corporate governance is increasing interest to SACCOs as it is considered to be one of the weakest areas in the industry (Olomy, 2015). According to Odera (2012) there are several

reasons for governance to be at the forefront of SACCOs debate of which among the major ones are, the tremendous growth in service providers of various types translates to a greater number of clients and assets, as well as more elaborate structure to manage. The challenge of evolving of institutions from focusing mostly on a single product to becoming more complete banking institutions that provide not only credit, but also savings and sometimes other types of financial

services such as money transfers, remittances, payment systems and insurance, therefore reinforcing the risks assumed by the SACCOs. Also in the recent past the behaviour of public authorities towards SACCOs' growth is also changing since their original neglect is being replaced by more proactive policies that create regulatory and supervisory frameworks supposed to favour sound development of the industry such as the introduction of SACCO's Societies Regulatory Authority-SASRA in Kenya.

Corporate governance in SACCO's is the system that helps in resolving conflicts of interest within the SACCO's, thus helping in reconciliation without endangering the long continuity of the SACCO's (Dagli *et al.*, 2010). Rose and Sharfman (2014) viewed corporate governance as both the structure and the relationships which determines corporate direction and performance. The board of directors is typically central to corporate governance. Its relationship to the other primary participants, typically shareholders and management, is critical. Additional participants include employees, customers, suppliers, and creditors. Corporate governance is seen as the whole set of measures taken within the social entity (enterprise) to favor the economic agents to take part in the productive process, in order to generate some organizational surplus, and to set up a fair distribution between the partners, taking into consideration what they have brought to the organization.

Corporate governance is the process of decision-making and the process by which decisions may be implemented. Sanda, Mikailu and Garba (2011) view corporate governance from the perspective of the investor as both the promise to repay a fair return on capital invested and the commitment to operate a firm efficiently given investment. This suggests that corporate governance has an impact on a firm's ability to access the capital market. Corporate governance also provides the structure through which the objectives of the SACCOs are set, and the means of attaining those objectives and monitoring performance are determined. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the SACCOs and its shareholders and should facilitate effective monitoring (Opanga, 2013).

Performance is the achievement of organizational goals in pursuit of business strategies that lead to

sustainable competitive advantage (Epstein & Buhovac, 2014). Hoque (2014) pointed out that to measure organizational performance more completely, one might use an approach similar to the balanced scorecard, which elevates non-financial measures to a level consistent with a traditional focus on financial measures. Financial performance is a subjective measure of how well a firm can use assets from its primary mode of business and generate revenues (KUSCCO, 2010). Financial performance is used as a general measure of SACCOs overall financial health over a given period of time, and can be used to compare similar SACCOs across the SACCOs industry or to compare firms or sectors in aggregation (SASRA, 2015).

In this age of global competition, technological innovation, turbulence, discontinuity, even chaos, change is inevitable and necessary. The organization must do all it can to explain why change is essential and how it will affect everyone. Performance refers to the act of execution, accomplishment or fulfilment, it is used to indicate firm's success, conditions, and compliance. Financial performance refers to the act of performing financial activity. In broader sense, financial performance refers to the degree to which financial objectives being or has been accomplished. Financial performance is the process of measuring the results of SACCOs policies and operations in monetary terms (Okiro & Ndungu, 2013). Financial performance measures firm's overall financial health over a given period of time and compares similar firms across the same industry or sectors in aggregation. There are many different ways to measure financial performance, but all measures should be taken in aggregation. Line items such as revenue from operations, operating income or cash flow from operations can be used, as well as total unit sales. Furthermore, the analyst or investor may wish to look deeper into financial statements and seek out margin growth rates or any declining debt (Dinc & Gupta, 2011).

Governance is a requisite for survival and a gauge of how predictable the system for doing business in any country is. In developing countries, the importance of governance is to strengthen the foundation of society and chip into the global economy. International standards and guidelines on corporate governance have been established by many multilateral organizations including the OECD and the Basel Committee in the effort to ensure improved legal institutional and regulatory framework for

enhancing corporate governance in institutions (Isaac & James, 2015).

The firm's capital, asset and earnings values are affected and as a result the financial performance is questionable, due to poor corporate governance. Transparency, disclosure and trust, which constitute the integral part of corporate governance, can provide pressure for improved financial performance. Allen and Maghimbi (2009) observed that some cooperatives were finding it difficult to operate largely because of their poor financial state. This was confirmed by the findings of the African Microfinance Transparency (AMT) report (2008) that discovered that funding structures indicated growth in SACCOs being mostly funded by access to debt rather than by savings. According to (Odera, 2012) profitability is not the primary concern for SACCOs. However, the WOCCU report (2012) looked at profitability of SACCOs from a different angle. It stated that SACCOs are required to make profits in order to directly benefit the owners as they (members) serve as both the owners of the SACCOs as well as the recipients of the SACCOs services. Thus when SACCOs maximize their profits, it results in the form of lower interest rates on loans, lower service fees and higher dividends for the members.

Corporate governance reflects the interaction among people and groups, which provides resources to the company and contributes to its performance such as shareholders, employees, creditors, long-term suppliers and subcontractors (Wasike, 2012). Studies conducted by Chipembere and Financial Sector Deepening (2009) assert that performance of SACCOs mainly is determined by the management and governance structures. In this regard, it has been noted that well governed SACCOs largely perform better and that good corporate governance is of essence to SACCOs financial performance. It is believed that good governance generates investor goodwill and confidence (Wandabwa, 2010). Again, poorly governed firms are expected to be less profitable. Claessens and Horen (2014) also posit that better corporate framework benefits firms through greater access to financing, lower cost of capital, better financial performance and more favorable treatment of all stakeholders.

In Kenya SACCOs are among the leading sources of the co-operative credit for socio-economic development (Mathuva, 2016). Savings and credit co-operatives are one of the leading sources of rural finance and in many rural areas the local SACCOs is

the only provider of financial services. They are an integral part of the Government economic strategy aimed at creating income generating opportunities particularly in the rural areas (Wachira, 2015). The co-operative movement has been recognized by the Government as a vital institution for the mobilization of human and material resources for various development progress particularly in the rural areas where the majority of people reside, earning their livelihood mainly from agriculture. Over the years, the co-operative movement remained predominantly agriculturally oriented. However, in the recent past, the co-operative movement has experienced significant diversification in activities and interests notably savings and credit. Other non-agro-based co-operatives have also emerged and ventured into areas such as housing; "Jua-Kali", building and construction, handicrafts, transport, small scale industries among others (Mathuva, 2016).

In Kenya, SACCOs are regulated by the government through the SACCOs Societies Regulatory Authority (SASRA). Societies Regulatory Authority is a Semi-Autonomous Government Agency under the Ministry of Industrialization and Enterprise Development (Omari, 2012). The Authority originates its powers to regulate the deposit taking SACCOs Societies in Kenya from the SACCOs Societies Act 2008 and the regulations issued thereunder. The mandate of the Authority as provided by the Act includes the following; license SACCOs societies to carry out deposit-taking business in accordance with this Act, regulate and supervise SACCOs, hold, manage and apply the general fund of the authority in accordance with the provisions of this Act, levy contributions in accordance with this Act, do all such other things as may be lawfully directed by the Minister and perform such other functions conferred on it by this Act or by any other written law. KUSCCO Limited, the umbrella body for SACCOs, has been awarded the 2013 (WOCCU) Outstanding Membership Growth Award. The award came in recognition of the fact that SACCOs in Kenya have the highest growth rate worldwide, a phenomenal attributed to formation of youth SACCOs, formation of Public Service Vehicle SACCOs, strong advocacy, expensive bank loans resulting to more people opting for affordable loans from SACCOs (WOCCU, 2013). According to SASRA, (2015) the number of SACCOs in Embu has tremendously grown. There are 95 registered SACCOs. However out of those SACCOs, 30 registered SACCOs are dormant while

65 registered SACCOs are active (Ministry of cooperative officers in Embu County, 2016).

### **Statement of the Problem**

Corporate governance is one of the criteria that investors should consider when selecting companies for investment. However, corporate governance often becomes the centre of discussion only after the exposure of a large scam. According to the Global Corruption Report of the year 2009, Kenya's financial sector is ailing from poor sectorial and corporate governance resulting in weaknesses that make pensioners, creditors, employees and depositors extremely vulnerable. Corporate frauds have continued to feature as a result of inadequate systems of corporate governance, leading to the collapse of some SACCOs. Poor corporate governance results to a number of challenges among them, poor governance, constant wrangles, limited transparency in the management of cooperatives and inadequate financing or adoption of financing models, corruption and mismanagement that results in poor service delivery and bankruptcy.

The study sought to answer the following empirical questions;

- i) What is the effect of board composition on financial performance of SACCOs in Embu County?
- ii) What is the effect of corporate risk management on financial performance of SACCOs in Embu County?

## **2.0 Literature Review**

The literature review is an outline of the previous research on a given topic. The sources of the literature review include; surveys, scholarly articles, books, and other relevant sources to a particular area of interest.

### **2.1 Theoretical Review**

There are numerous theories that can be used to explain the relationship between corporate governance and financial performance of SACCOs. The study is anchored on the agency theory and the prospect theory.

#### **2.2.1 Agency Theory**

Agency theory according to Sachs (2014) explains how to best organize relationships, in which, one

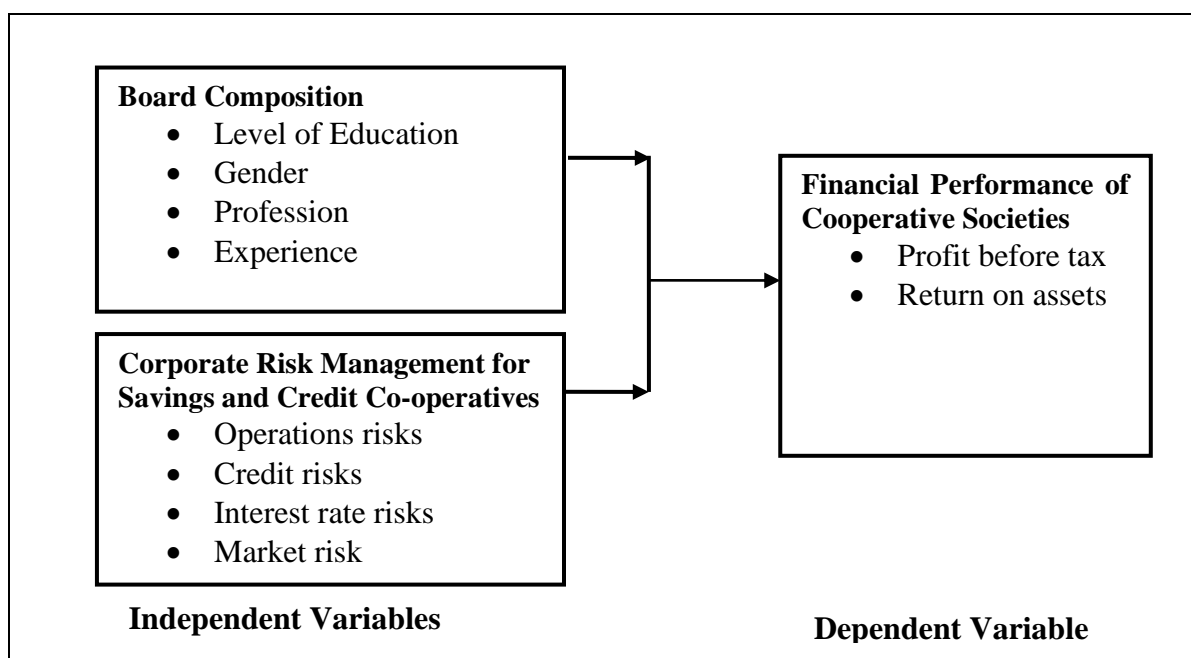
party determines the work while the other party does the work. In this kind of the relationship, the principal hires an agent to perform the work, or to do the task, the principal is either unable or unwilling to do the work. According to the theory shareholders expect the agents to act and make decisions in the principal's interest. On the contrary, the agent may not necessarily make decisions in the best interests of the principals (Padilla, 2002). To align agent-principal interests, earlier agency theorists (Demsetz & Lehn, 1985; Jensen & Meckling, 1976; Fama & Jensen, 1983) suggested that managers/directors be monitored by the board of directors. Thus the size of the board and the number of executive directors on the board are regarded as proxies for board of directors when it is measured against firm performance. This theory attempts to explain what could be the optimum number of board members for governorships of SACCOs so that they can maximize on the profits.

#### **2.2.2 Prospect Theory**

Prospect theory was developed by Kahneman and Tversky in 1979. The prospect theory asserts that decision making under risk can be viewed as a choice between prospects or gambles and the decisions subject to risk are deemed to signify a choice between alternative actions, which are associated with particular probabilities (prospects) or gambles. Prospect theory states that decisions in risky situations are made based on values assigned to gain and losses with respect to a reference point and decision weights. Tvede, Pircher and Bodenkamp (1999) explained that the human beings have an irrational tendency to be less willing to gamble with profits than with losses. This means selling quickly when we earn profits but not selling if we are running losses. Prospect theory helps in explaining how loss aversion, and an inability to ignore sunk costs, leads people to take actions that are not in their best interest (Epley & Gilovich, 2006).

**2.3 Conceptual Framework** The dependent variable in this study was the financial performance of savings and credit co-operatives while the independent variables were board composition and board independence as shown in Figure 1.





**Figure 1: Conceptual Framework**

## 2.4 Empirical Review

Studies linking corporate governance and financial performance have been undertaken. Otieno, Mugo, Njeje and Kimathi (2015) examined the effect of corporate governance on financial performance of savings and credit cooperatives. The study found out that there was a significant relationship between financial reporting and financial performance of savings and credit cooperatives. Maina (2014) examined the effects of board composition on firms performance on all quoted firms in Kenya and found no significant relationship between firm's performance and board composition. Wetukha (2013) in Kenya examined the relationship between board size and board composition on firm performance - A study of listed companies at the Nairobi stock exchange. The study found that there was no significant relationship between board size and firm valuation. Savings and credit cooperatives with more frequent financial reporting structures showed better financial performance. From the literature review, good corporate governance is of paramount importance in all organizations regardless of their industry, size or level of growth. Good corporate governance has a positive economic impact on the SACCOs as it saves various losses occasioned by frauds, corruption and similar irregularities. Besides, it also spurs entrepreneurial development enabling the SACCOs to better seize the economic opportunities that come on the way.

Kanyiri et al., (2018)

### 2.4.1 Board Composition

Board composition is one of the important factors affecting firm financial performance. According to Kamonjo (2012) a board fulfils three major tasks; it links the organization to its environment and secures critical resources, the board also has an internal governance and monitoring task and lastly it can discipline or remove ineffective management teams. An effective board depends on both the diverse collection of skills and competencies that individual director bring with them and the training that the board provides to help directors master board issues and develop the skills needed to participate effectively.

### 2.4.2 Corporate Risk Management

The corporate risk management is the cornerstone of prudence in SACCOs practice (Lesirma, 2014). Corporate risk management refers to the methods that SACCOs uses to minimize its financial losses. Risk is the potential that current and future events, expected or unanticipated may have an adverse or harmful impact on the institution's capital, earnings or achievement of its objectives (Magali, 2013) assert that risks occurring in SACCOs can hamper SACCOs performance if not dealt with properly.

## 3.0 Research Methodology

This section discusses the methodology that was

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used to conduct the study. The research methodology used are discussed; the research design, target population, research instruments, data processing and analysis techniques.

### 3.1 Research Design

The study adopted a descriptive research design. Descriptive research design is an assessment of the situation of affairs describing, analyzing and reporting conditions that exist or that existed. A descriptive research design is premeditated to gain more information about variables within a particular field of study. Its purpose is to provide a picture of a situation as it naturally happens. A descriptive research design was used because it deals with clearly defined problems with definite objectives. Thus being a descriptive study, the researcher aimed to unveil the effects of the corporate governance on financial performance of SACCOs in, Embu County, Kenya.

### 3.2 Target Population

The target population of the study composed of the 65 savings and credit co-operatives in Embu County, Kenya that were actively in operation. The SACCOs are grouped into five sub-counties found in Embu County. The Sub-counties are, Embu West- Embu town, Embu North- Manyatta, Embu East- Runyenjes, Mbeere North- Siakago and Mbeere South- Kiritiri.

### 3.3 Data Collection Instruments

The study relied on both primary and secondary data. In the study the self-administered semi-structured questionnaires were used to gather the needed primary data. Secondary data was sourced from audited financial statements, annual reports and SACCOs magazines.

### 3.4 Model Specification

It is the process of defining the independent variables that one needs to include or exclude from the regression equation. The study used the following regression model to determine the relationship between the independent variables (corporate risk management for savings and credit co-operatives and board composition) and the dependent variable (financial performance).

$$Y = \beta_0 + \beta_1 X_1 + \beta_3 X_3 + \varepsilon$$

Y is Dependent variable (financial performance)

X1 is Board composition

X3 is Corporate Risk Management for SACCOs

### 3.5 Variable measurement

The study has two independent variables (board composition and corporate risk management for SACCOs) while, the dependent variable was financial performance. The board composition was measured by considering the four factors regarding the board members; level of education, gender, profession as well as their experience. The corporate risk management of SACCOs was measured by the following parameters; SACCOs operations risk, credit risk, Interest rate risk and market risk. The study used the two indicators; profit before tax and return on assets to measure the dependent variable for SACCOs (financial performance).

### 4.0 Research Findings and Discussions

In order to ascertain the relationship between the independent variables and the dependent variable, the study establishes the influence of the independent variables on the dependent variable. Therefore, this section outlines the results on both correlation and multiple regression analysis.

#### 4.1 Board Composition and Financial Performance of SACCOs

The correlation between the board composition and the financial performance of SACCOs in Embu County was determined. Table 3 shows the results of the correlation analysis. The results reveal that the board composition and the financial performance had positive correlation, which was moderate and statistically significant at 5% confidence level at ( $r = 0.394$ ,  $p < 0.05$ ). This implies that carefully looking at the composition of the board members leads to an improvement of the financial performance of the savings and credit cooperatives. Similar findings were advanced by a study conducted by Kamonjo (2012) which found out that careful consideration of board composition has a positive effect on the financial performance of savings and credit cooperatives.

**Table 3: Correlation between Board Composition and Financial Performance of SACCOs**

Board Composition	Financial Performance	
	Pearson Correlation	.394**
	Sig. (2-tailed)	.003
	N	44

\*\* . Correlation is significant at the 0.05 level (2-tailed).

#### 4.2 Corporate Risk Management and Financial Performance of SACCOs

The correlation between corporate risk management and financial performance of SACCOs is presented in Table 4. The research outcome shows that, there is a weak positive relationship that is not statistically significant ( $r = 0.228$ ,  $p > 0.137$ ). These findings imply that, when SACCOs implement an effective

corporate management risk systems, then, there are minimal chances of losses occurring in SACCOs, hence an increase on the financial performances of the SACCOs. A study carried by Magali (2013) found that corporate risk management of SACCOs had a weak positive correlation with financial performance of the SACCOs, these findings are agreeing with the findings on the Table 4.

**Table 4: Correlation between Corporate Risk Management and Financial Performance of SACCOs**

Corporate Risk Management for SACCOs	Financial Performance	
	Pearson Correlation	.228
	Sig. (2-tailed)	.137
	N	44

#### 4.3 Regression Analysis

The multiple regression analysis generally enables the researcher to confirm the effect between the independent and dependent variables. The coefficient of determination ( $R^2$ ), which is the proportion of variation in the dependent variable (financial performance) that is explained by the four independent variables, was used to measure the

relationship between corporate governance and financial performance of SACCOs. Table 4.18 shows that the coefficient of determination ( $R^2$ ) in this study was 40.20%, this means that the model projected explicates 40.2% of the variations in the financial performance of Savings and credit cooperatives is backed by corporate governance.

**Table 5: Model Summary**

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.634 <sup>a</sup>	.402	.353	.48843

#### 4.4 Analysis of Variance

The Analysis of Variance (ANOVA) was used to test the significance of the relationship of the study variables. The findings on the ANOVA, are presented in Table 4.19, where the findings shows that F-statistic had a value of 6.558 and P-value was 0.000. The obtained value of P (0.000) revealed that

this value is below the 0.05 level hence, the overall regression model is statistically significant, or the variables (board size, board composition, corporate risk for SACCOs management and board independence) have a significant combined effect on the dependent variable (financial performance of SACCOs).



**Table 6: ANOVA**

	Sum of Squares	df	Mean Square	F	Sig.
Regression	6.258	4	1.565	6.558	.000 <sup>b</sup>
Residual	9.304	39	.239		
Total	15.563	43			

#### 4.5 Overall Model

The regression coefficients of the variables (board size and management for SACCOs) of the findings of the study are shown in the table 7.

**Table 7: Coefficients**

	Unstandardized Coefficients		Standardized Coefficients		Sig.
	B	Std. Error	Beta	t	
(Constant)	.460	.952		.484	.021
Board Composition.	.448	.196	.299	2.284	.028
Corporate Risk Management for SACCOs.	.056	.147	.050	.377	.708

The interpretations of the overall significant test findings for the hypothesized research model shown in Table 4.20 follow the multiple regression model that is shown:-

$$Y = .460 + 0.448X_1 + 0.056X_3$$

.....Equation 1

The findings show that the constant (0.460) was statistically significant ( $p=0.021<0.05$ , this means that when one takes all the independent variables value at zero, the results for financial performance of the SACCOs would be 0.460. It was noted that the corporate governance investigated in the study significantly influenced the financial performance of the SACCOs. The regression coefficient for the board composition (0.448) was statistically significant ( $t = 2.284$ ,  $p= 0.028<0.05$ ). This shows that holding other independent variables to zero, an improvement in board composition by a unit results to an increase of 0.448 units on the financial performance of SACCOs. The findings are consistent with a study by Kamonjo (2012) which found a significant positive effect on board composition to the financial performance of SACCOs.

The corporate risk management of the SACCOs had a regression coefficient of (0.056), which was statistically not significant ( $t = 0.377$ ,  $p = 0.708 >0.05$ ), a unit increase in corporate risk management

of the SACCOs would require 0.337 unit increase in financial performance, but this was not statistically significant. The findings agreed with the findings conducted by Onyango (2016) which revealed that there was minimal effect of corporate risk management of the SACCOs on the financial performances of the SACCOs. The study findings show that the board members composition helps in bringing ideas, valuable skills and helping the management of SACCOs to build a more transparency and accountable systems of management hence, being very beneficial to the financial performances of SACCOs. The findings from the study also reveals that the board composition and the financial performance have a positive relationship. This means that identification of board members should put into consideration their level of education, age, professional qualifications and leadership skills in order to achieve better financial performance of SACCOs.

The study also found out that most of the savings and credit co-operatives had implemented the corporate risk management policy for SACCOs. The findings established that corporate risk management of the SACCOs had a minimal impact on the financial performance of SACCOs. The findings further revealed that, effective implementation of corporate risks management system by the SACCOs, reduces chances of losses occurring in the SACCOs, hence increasing the financial performances of the SACCOs. The relationship between corporate risk management of the SACCOs and the financial

performance of the SACCOs was positive and not significant.

### 5.0 Conclusion and Recommendations

The board composition had a positive relationship with the financial performance. A well composed board, keenly looks at the following factors; education level, gender, leadership skills and the professional qualifications of the board members. A board of members that is well composed, ensures, good decisions are made, operations are conducted more efficient and apposite implementations of the strategic plans in the SACCOs. Valuable skills in the SACCOs leads to excellent operational and managerial skills, these skills are brought by a well composed board of members, hence increasing the financial performance of the savings and credit cooperatives.

The board independence had a positive relationship with the financial performance. Board of directors needs to have regular meetings, so that they can deliberate on SACCOs progress, hence making various decisions that affect the SACCOs general objectives. Regular board of directors meetings, ensures that there is frequent deliberations and communications, which leads to more cohesion among the directors and by that, it reduces the conflicts of interest among the directors.

The study recommends that the members of the SACCOs board should comprise of well-educated individuals who are actively involved in shaping SACCOs strategy. The study also recommends that,

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the gender parity in leadership of SACCOs should be observed as per the requirements by the Kenyan constitution. The professional qualifications of the board members of the SACCOs, their leadership skills and experiences had a great impact on the financial performance of the SACCOs, therefore the study recommends the embracement of the same during appointments of the board members of the SACCOs.

Savings and credit co-operatives should embrace the board independence in their operations in order to improve their financial performance. Savings and credit co-operatives should ensure that during their appointments, that the appointments' of the board of directors should be through a well-managed and an effective process, to ensure there is a balanced mix of proficient among the designated individuals. These selected individuals are able to add value to the savings and credit co-operatives by bringing independent judgment that positions the decision making process.

### 6.0 Suggestion for Futher Research

This study determined the effect of corporate governance on the financial performance of the Savings and Credit Cooperatives in Embu County, Kenya. This study focused on two independent variables (board composition and board independence) therefore, further research can be done to know whether, more variables exist that influences financial performance of SACCOs.

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